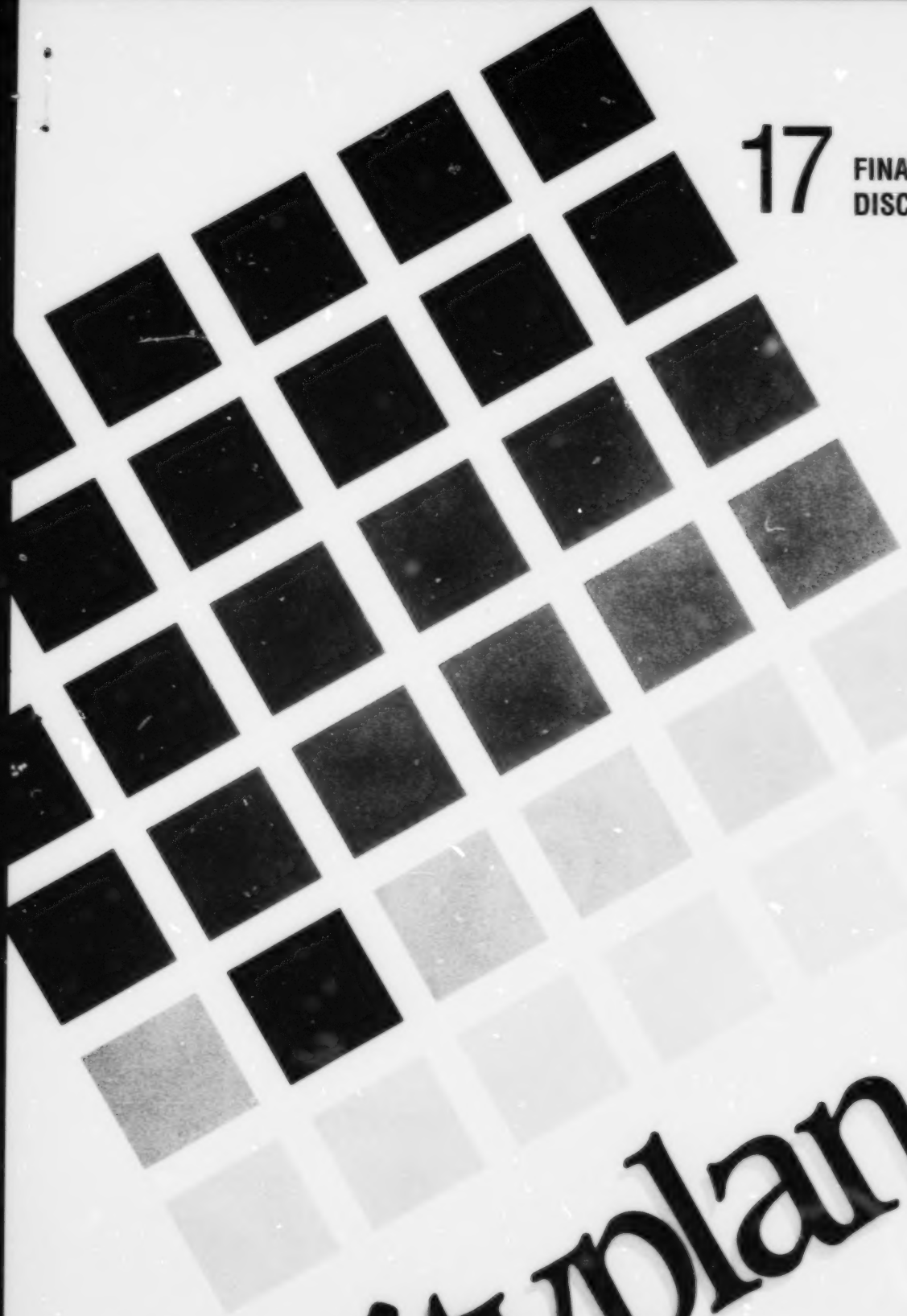


17 FINANCIAL SERVICES DISCUSSION PAPER

# Cityplan '91

City of Toronto
**Planning & Development** Department

Robert E. Millward
Commissioner

ERRATA - BACKGROUND PAPER #15

91-03017/

Figure 2 which appears on pages 5 and 43 showed an addition sign when it should have showed a division sign between the last two boxes of the model.

This sheet should replace the figures on those two pages.

Figure 2

**A Model for Estimating Social Housing Targets**


Social Housing to be constructed per year
=
Total number of units expected over the projection horizon
x
Expected tenure split
x
Percent of total households facing affordability problems
x
Percent of households facing affordability problems that are in deep need
÷
Number of years of projection time horizon

# 17

# FINANCIAL SERVICES DISCUSSION PAPER

**January 1991**

**$ 7** (shipping and handling extra)

City of Toronto
**Planning & Development** Department

Robert E. Millward
Commissioner

For further information please contact Peter Viducis at 392-1005, Economic Development Division, City of Toronto, Planning and Development Department.

# Contents


**1 Introduction** *1*

**2 Financial Services in Toronto** *3*

Central Area Employment Trends *3*
Occupation Profile and Labour Incomes *5*
National Trends in Output and Employment *7*

**3 Impetus for Change** *11*

Technological Changes *11*
Socio-Economic Changes *12*
Inflation and Exchange Rates *13*
International Capital Flows *16*
Third World Debt Crisis *17*
Regulatory Changes *18*

**4 Response to Change** *21*

Innovation (New Products/Services) *21*
- Euromarket Securities *21*
- Financial Futures and Options *22*
- Swaps *24*
- Asset-Backed Securities *25*

Internationalization *26*
- Market Linkages *26*
- International Financial Markets *27*
- International Financial Centres *28*

**5 Conclusions** *33*

**6 Bibliography** *37*

**Appendix** *39*

Table 1: FIRE Employment in Canada
Table 2: Central Area Total Employment
Table 3: Central Area vs. Metro Employment
Table 4: FIRE Labour Force Profile
Table 5: Financial Centre Employment

# 1

# Introduction

At its meeting on October 3, 1988, City Council adopted *The Final Report of the Downtown Employment Study Steering Committee*, which included a work plan for an in-house study of the financial services sector in Toronto.

The principal reason for the study was that a number of the consultant's studies for the Downtown Employment Studies Work Group indicated that future office absorption rates would likely be closely linked with employment growth in the financial services sector. It was also noted that the financial services sector was currently going through substantial changes as a result of a number of environmental transformations, not the least of which is the deregulation of the industry.

This report first provides a profile of the financial services sector in Toronto and examines employment and output trends over the last twenty years. The second section investigates the changes that have occurred in the environment within which the financial services industry operates, and the third section looks at the response of Canadian firms to the environmental changes identified above. The final section synthesizes the material presented in the first three sections and concludes that in the long-run financial services employment in Toronto is likely to continue to expand.

The financial services sector in Canada is comprised of what have traditionally been called the four pillars: commercial banks, trust companies, securities firms, and insurance companies. In addition, the financial services sector includes pension funds, mutual funds and other institutional investors, finance companies, credit unions and co-operatives, venture capitalists, insurance agents, investment advisors and the institutions organized to facilitate and regulate the delivery of financial services.

Real estate developers and brokers are often combined with financial services to form a category called FIRE (Finance, Insurance and Real Estate), used in many recent data series. FIRE statistics are used in this report when data were unavailable based on the narrower definition of financial services. In the Central Area, employees in financial services firms account for more than ninety percent of FIRE employment.

The role of the financial services sector in the economy is commonly perceived as facilitating the transfer of funds from net savers to net borrowers. However, financial services firms also provide a number of other important services including maintaining a payments system, supplying information, and providing safekeeping services.

By intermediating the transfer of funds, financial services firms also transform assets and risks. Arguably, this is the most important contribution the financial services industry makes to real output (and hence potential consumption) in the economy. Individual lenders and borrowers have varied exchange rate and (debt instrument) maturity preferences, as well as varied preferences for and capacities to bear business (i.e. default) risk and financial (i.e. interest rate and inflation) risks.

While the size of the total economic "pie" is increased by matching these individual preferences, further increases in wealth also result through diversification, because most individuals and organizations are risk averse. When an individual diversifies his/her wealth portfolio, it is possible to reduce risks without reducing expected rates of return. For example, by investing in ten business enterprises rather than just one, it is possible to reduce the risk of losing one's entire investment. Efficient financial markets permit investors, even with relatively small portfolios, to benefit from diversification.

# 2

# Financial Services in Toronto

Table 1 in the Appendix shows the growth in FIRE employment in Canada from 1976 to the present. FIRE employment increased by 52 percent over the past fourteen years in Canada, while total employment increased by 33 percent. In the Toronto CMA FIRE employment grew by 73 percent while all employment grew by 44 percent. This employment growth is even more pronounced in Toronto's Central Area. Between 1981 and 1989, FIRE employment grew by 30 percent in the Central Area, compared to a 24 percent increase across the Toronto Census Metropolitan Area and a 23 percent increase across Canada. By 1989, financial services employees accounted for 19 percent of total employment in the Central Area (see Table 2 in the Appendix).

## Central Area Employment Trends

According to annual surveys by the Metropolitan Toronto Planning Department, in 1989 the financial services sector employed 80,300 persons in the Central Area, approximately two thirds of total financial services sector employment in Metro Toronto (see Table 2 and Table 3 in the Appendix). This concentration of employment in the Central Area is particularly pronounced among securities firms, where 90% of Metro employment is in the Central Area. Similar concentrations of employment in the Central Area were also observed in the business services sector for Law Firms (78%) and Chartered Accountants (59%), which supply many services to the FIRE sector. In 1989, FIRE employment in the Central Area totalled 86,400, approximately half of the CMA total.

Total employment in the financial services sector increased by 17,300 jobs (27%) from 1983 to 1989 in the Central Area (see Table 2 in the Appendix). While brokerage firms and Schedule "B" (mostly foreign) banks increased their employment levels substantially, analysis of the data at an individual firm level yields the surprising result that **more than three quarters** of the increase is accounted for by the five largest Canadian banks[1], who increased their total employment in the Central Area by 120% between 1983 and 1989. These employment increases are in addition

[1] Toronto Dominion Bank, Bank of Montreal, Canadian Imperial Bank of Commerce, Royal Bank of Canada and Bank of Nova Scotia.

to the increases in bank employment resulting from the bank purchases of the major brokerage firms, and occurred over a period which saw substantial deconcentration of several functions (particularly data processing) to the suburbs.

In 1989, 28,900 persons worked for the big five Canadian banks in Toronto's Central Area, more than one third of total financial services employment, and 72 percent of total bank and trust company employment. The smallest but most profitable of the five big banks, the Toronto Dominion Bank is the largest financial services employer in the Central Area, with 28% of its Canadian employees located in Toronto's Central Area. The other four large banks have between 13 and 18 percent of their domestic employment in Toronto's Central Area.

Forty eight of the sixty six chartered banks registered in Canada have their head offices in Toronto. The remainder are split almost evenly between Montreal and Vancouver. The Toronto Dominion Bank, and the Canadian Imperial Bank of Commerce have their head offices located in Toronto. The Bank of Nova Scotia, while maintaining a nominal head office in Halifax, has relocated its executive offices to Toronto. The Royal Bank, which has its head office in Montreal, has the vast majority of senior staff (vice-presidents and senior vice-presidents) located in Toronto. Only the retail banking and personnel functions of the Royal Bank are centred in Montreal. The Bank of Montreal, also headquartered in Montreal, describes First Canadian Place in Toronto as "Bank of Montreal's executive and operational nerve centre."[2]

Foreign banks, which are often assumed to have generated a large part of the employment boom in financial services in Toronto, increased their total employment from 2,000 in 1983 to 3,100 in 1989, according to the Metro Planning Department's employment surveys. During the same period, Investment Services and Financing Companies (mostly brokerage firms) increased their total employment from 14,500 to 16,700.

Table 2 indicates that employment in insurance companies declined by 5400 during this same period; however, most of this apparent decline appears to result from a number of data anomalies in the 1983 survey. On balance, it would appear that employment at insurance companies remained largely stable between 1983 and 1989. Even though a number of large insurance companies relocated to the suburbs (Prudential Insurance, North American Life and Wellington Insurance), employment increases at the remaining firms have offset these loses.

The increases in financial services employment in the Central Area after 1983 appear to be a continuation of trends established during the 1970s. Between 1971 and 1986, full-time FIRE employment increased by 54 percent in Toronto's Central Core (an area slightly smaller than the Central Area). In this earlier period, as after 1983, more

[2] Bank of Montreal, *Annual Report (1989)* p.23.

than half of the increase was accounted for by increases in the banks and trust companies, which increased employment by 115 percent from 1971 to 1986.[3]

## Occupation Profile and Labour Incomes

The data in this section are from a number of special runs produced by Statistics Canada for the Planning and Development Department from the 1986 Census. These data are based on a 20% sample of the Greater Toronto Area (Metro and the Regional Municipalities) population and are presented in tabular form in Table 4 in the Appendix below. Statistics Canada data are collected by place of residence and therefore are not useful below the CMA or GTA level in estimating employment by place of work.

Three quarters of the FIRE labour force can be classified in three broad categories. The largest group is clerical and related with 35% of FIRE employees, as compared with 18% in all industries. Also significant are the market search and coordination (21%) and consulting services (20%) groups.

Clerical employees, are one of the lowest paid groups in the FIRE sector, 74% of employees in this category were paid less than $20,000 per year in 1985. While the income distribution of employees in all industries is roughly similar, there are significantly fewer employees in the lowest (less than $10,000) category in FIRE (25%) than all industries (30%) and also fewer clerical employees earning more than $20,000 in FIRE (26%) than all industries (31%). When the income profile is generated for full-time employees only, a similar pattern emerges, with fewer very low paid and fewer highly paid clerical employees in the FIRE sector than in all industries. On average, it would appear that clerical employees are paid roughly the same in the FIRE sector as in other sectors. Clerical employees in the FIRE sector also tend to be younger than the all industries average (only 19% of FIRE clerical staff are over 45 years old vs. 24% in all industries). They are less likely to work part-time (21% of FIRE clerical employees work part-time vs. 25% of all industries clerical employees) and are more likely to be women (86% vs. 78%).

The market search and coordination group (21% of FIRE employees) includes both retail and institutional salespersons of securities, insurance and real estate, as well as securities traders and investment bankers. Almost 40% of all employees in this category in all industries in the GTA are employed by FIRE firms. This group is better paid than average in all industries and particularly in the FIRE sector. 21% of employees in this category are paid more than $50,000 versus 14% in all industries. Otherwise the income distribution of market search employees is very similar to the all industries average. Market Search and Coordination employees in the FIRE

[3] Hemson Consulting Ltd., *Outlook for Office Employment and Space in the Central Core* (1987) p. 14.

sector also tend to be a little older then in all industries (36% are over 45 in the FIRE sector versus 31% in all industries). More women are employed in market search and coordination positions in the FIRE sector than in all industries (38% versus 34%).

The third largest group of FIRE employees are categorized in the consulting services group, which includes loan managers, research analysts, accountants and computer programmers. Employees in this group are also relatively well paid; however, their income distribution is narrower than market search employees (relatively fewer employees earn less than $20,000 or more than $50,000). In this category, FIRE employees are also better paid than their counterparts in other sectors and are also more likely to be women (46% versus 39% in all industries).

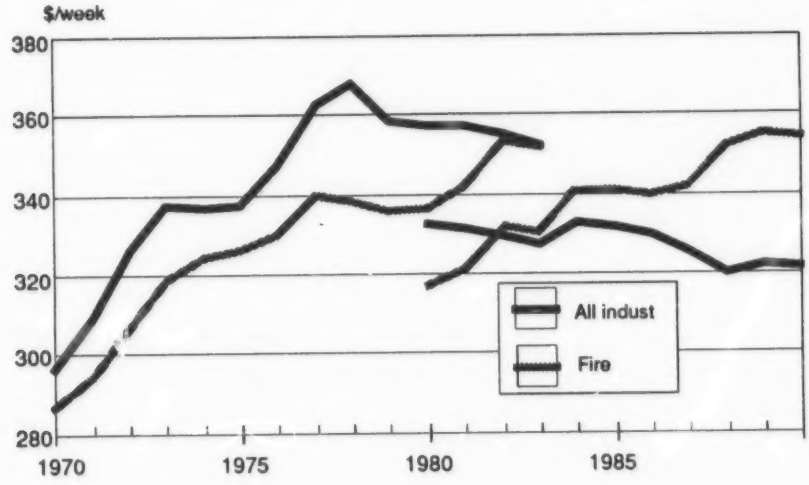
Administrative and management employees comprise a somewhat smaller share of total employment in the FIRE sector than all industries (7% versus 9% in all industries). They are much more likely to be women than in all industries (40% versus 31%) and are more likely to be earning over $50,000 per year (37% of administrative and management employees in the FIRE sector versus 28% in all industries)

The remaining 18% of FIRE employees not identified in any of the four categories listed above are engaged in a variety of activities. The most significant of these are: supervisory and process control (4%), information machine workers (4%) and non-information occupations (6%). Supervisory and information machine workers tend to be paid less and are more likely to be women in the FIRE sector than in other industries.

Data from the Statistics Canada monthly survey of employment, earnings and hours (Catalogue 72-002) also supports the conclusion that FIRE employees are paid more than the average in all industries. In 1989, on an Ontario-wide basis, FIRE employees were paid an average of $584.15 per week, whereas the all industry average was only $509.08. The same relationship exists at a national level, though it is less pronounced.

Chart 1 shows the changes that have occurred, at the national level, in average weekly earnings in the FIRE sector and in all industries. Statistics Canada substantially increased the coverage of their employment earnings survey in 1983 and backward linked data is only available to 1979; therefore, two series are shown for each sector. The FIRE sector, was a low paying sector in the 1970s; however, FIRE sector employment incomes continued to rise in real (after-inflation) terms after the late 1970s when employment earnings in other sectors began to decline in real terms. In 1982, employment incomes in the FIRE sector began to exceed those in the economy as a whole. During the 1980s the gap between FIRE incomes and all other sectors continued to widen.

*Chart 1*
**Average Weekly Earnings**
**Constant 1981 $**




These increases in relative incomes in the FIRE sector are explained in part by this sector's increased propensity to hire well educated persons. In 1971 only 6.2% of FIRE employees had university degrees nationally, compared to 6.9% of employees in all industries. By 1981, 11.0% of FIRE employees had university degrees versus 10.7% in all industries. While all industries increased their employment of university graduates by 118% between 1971 and 1981, FIRE firms increased university graduate employment by over 200%.

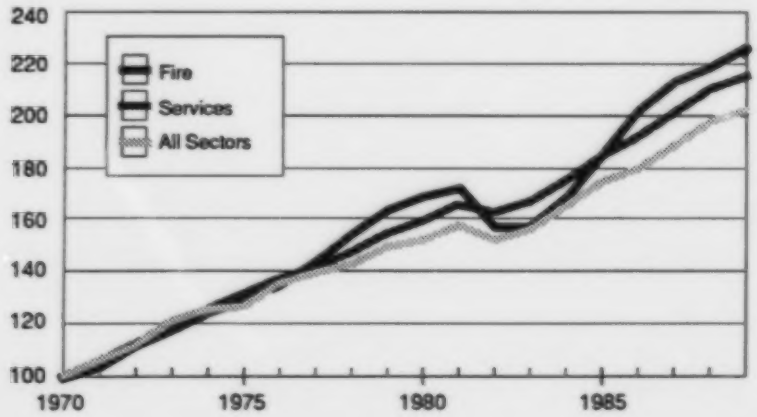
## National Trends in Output and Employment

Over the past two decades Canada's gross domestic product has doubled in real terms (after the effects of inflation). Between 1970 and 1989, GDP increased at an annually compounded rate of 3.7%. During this same period the output of all services producing industries increased at an annual average rate of 4.2% and the FIRE sector (part of the services sector) increased by 4.5%. By the third quarter of 1989 (the latest period for which data were available at the time of writing), the FIRE sector contributed 7.0% to total output and 11.5% to total services output.

The GDP series used in this report to represent the output of the FIRE sector is considerably narrower than that often reported as "FIRE" by Statistics Canada; the latter includes imputed rent on owner occupied dwellings and government royalties on natural resources. While these two additional categories can be reasonably considered part of the output of the real estate sector, they bear no relation to the current output of real estate developers and brokers. By excluding these two sources of FIRE output, a better match is obtained with FIRE employment, and hence more meaningful measures of GDP per employee.

Chart 2 shows the relative growth of FIRE, all services and total GDP since 1970.[4] Year-to-year fluctuations in FIRE output levels are in part the result of imputing output levels from the spread between interest earned and interest paid by financial intermediaries. Deposit taking institutions do not always exactly match the maturities of their deposits and loans; therefore, imputed output levels show realized rather than contracted rates of return. While the drop in FIRE output between 1981 and 1982 (and the rapid increases between 1976 and 1980 as well as between 1983 and 1987) may be partly explained by these measurement problems, it appears that FIRE output is more volatile than the output of the entire economy, unlike service sector output as a whole.

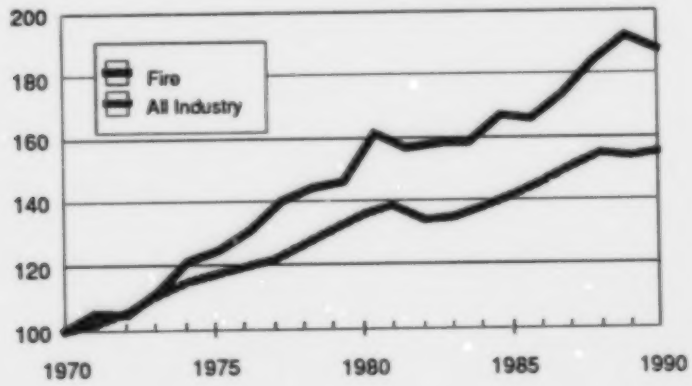
*Chart 2*
**Canadian GDP (1970=100)**




[4] Financial services sector output is estimated differently than the output of other sectors in the economy, because the usual treatment of interest earned and paid results in anomalous measures of output for the financial services sector. For a discussion of the theoretical basis for imputing financial services output, see John F. Chant, *The Market for Financial Services: Deposit-Taking Institutions*

Employment in the FIRE sector has also grown substantially since 1970, from 376,000 to 755,000 in 1990 (Table 1 in the Appendix). As a proportion of total employment nationally, FIRE has increased from 4.7% to 6.0%. Chart 3 shows the relative increases in FIRE and all industry employment nationally, since 1970.

*Chart 3*
**Canadian Employment**
**1970=100**




Comparing the employment series with the output series indicates that though output per employee has grown in the FIRE sector, it has been increasing at a slower rate than in other industries. Labour productivity, however, remains substantially higher in the financial services sector than in other sectors of the economy (Chart 4).

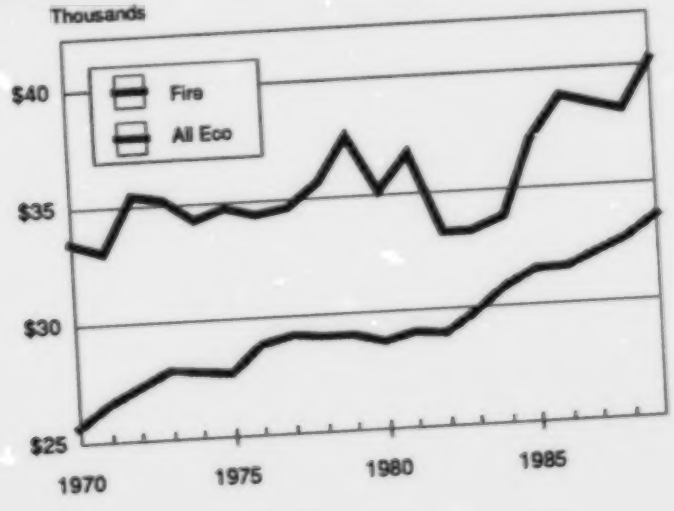
One possible explanation for slower growth in labour productivity in the FIRE sector than the rest of the economy is provided by John Chant. He notes that labour is used in two separate ways in the financial services sector:

> *Labour is employed directly as a productive input in producing financial services. In addition to this labour directly employed in the sector, labour must also be supplied by users of the industry's output to gain the full benefits of its services. Thus, increases in productivity can reduce either of the labour inputs. When an innovation occurs in the internal processes of the deposit-taking industry, it results in an increase in output per worker. On the other hand, when the innovation occurs in the nature of services*

*offered by the industry, it represents an improvement in the quality of output and escapes measurement even though it may result in saving of effort by the customers of financial institutions.*[3]

A good example of the latter effect is provided by the introduction of automated teller machines, which allow customers to execute many bank transactions at their convenience, 24 hours a day and 7 days a week, reducing the amount of time they spend travelling to and from banking transactions, and allowing them to maintain smaller cash balances, because of the greater flexibility in replenishing those balances when required.

*Chart 4*
**GDP/Employee**
**Constant 1981 $**




[3] John F. Chant, *The Market for Financial Services: Deposit-Taking Institutions* (1988) p. 67

# 3

# Impetus for Change

The growth of financial services output and employment over the last twenty years has resulted from a number of changes in the environment for financial services in Canada and the rest of the world. The following section examines these changes, in order to determine what impacts they have had on financial services employment and output and whether these trends are likely to continue.

The changes in the environment for financial services have been grouped into six categories in the following section. To identify which changes have had the greatest impact is a somewhat arbitrary exercise, because many of the changes that have taken place in the financial services sector are the result of two or more of the environmental changes identified below. For example, technological changes have permitted the introduction of many new products, which would have been prohibitively expensive without the new technologies. However, in many cases there would have been little demand for the new products without other environmental changes - for example, increased volatility in interest rates and the increased sophistication of investors.

## Technological Changes

Generally, the introduction of new technology has lowered the cost of many financial transactions, increased the speed at which transactions take place and increased the convenience for customers.

In the banking sector, the first significant innovation was the introduction of magnetically encoded cheques in 1962. It is estimated that the cost saving for banks from this innovation was in the order of two-thirds of the cost of processing a cheque. In addition to reducing the labour required to process cheques, this technology has altered the spatial distribution of bank employment. Whereas before the 1960s primary sorting of cheques was done at the local branch, the new technology gave rise to regional bank data centres[6]. These regional data centres are located across Canada, because of the need to physically transport cheques from the bank branches to the data centres.

[6] H. Binhammer and J. Williams, *Deposit-Taking Institutions and the Process of Change*

Chargex (now VISA) cards were introduced in 1968. Unlike the magnetically encoded cheque technology, this innovation substantially changed the nature of the financial services product offered to the consumer. This innovation also created a demand for centralized transaction processing facilities.

The electronic transfer of funds, in turn lead to tremendous changes to retail banking, allowing multiple-branch banking and the introduction of on-line automated teller machines in 1972. ATMs have further reduced the need for relatively unskilled and low-paid clerical staff in the deposit-taking sector, as well as reducing the importance of the banks' branch network.

Improvements in computer technology have also permitted the introduction of new products such as daily interest on deposits and weekly or bi-weekly loan payments.

New technologies have improved the decision-making process in the FIRE sector as elsewhere in the economy. For example, the introduction of microcomputers and specialized software has reduced the cost of providing portfolio management services, which previously were available only to the largest institutional accounts. Improvements in communications technology now allow even a small retail investor to access up to the minute information about markets throughout the world. Finally, without electronic spreadsheet and other financial analysis software the cost of many of the more complicated financial products would be prohibitive.

Major advances in computer and telecommunications technology over the last twenty years have greatly reduced the natural protection provided by distance. For example, it is no longer necessary for two parties to meet face to face in order to trade securities. It is now possible to complete deals more quickly and at less cost than ever before. Without the advances in communications technology experienced over the last two decades the growing globalization of financial markets would not have been possible.

Advances in knowledge, which are not embodied in any particular piece of machinery, have also allowed financial firms to offer new products and services to their clients. Examples of such advances include the ability to interpret interest rate caps and floors as options and to use option pricing theory to determine the offsetting positions in the option market to positions in equity markets.

## Socio-Economic Changes

The expansion of the financial services sector experienced in the last twenty years, not only in Canada but also in most Western countries, was caused by a number of underlying trends in the economy. On the demand side the most significant of these

trends was the rising real incomes[7] of individuals and the increased sophistication of both lenders and borrowers.

Real incomes per capita have risen by more than 90 percent since 1970 in Canada; however, financial markets are growing at an even more rapid rate as households, corporations and governments increasingly turn to financial markets to meet their investing and borrowing needs. In addition, financial assets are being traded more often.

More recently, the aging of the population is also increasing the demand for many financial services, as the baby boom generation begins to enter the stage of life when they become net savers in preparation for retirement. This large well educated group is demanding more sophisticated financial products than previous generations. Whereas in previous generations most people were content to accumulate savings in bank accounts and life insurance policies, today increasing numbers of investors have complex self-directed portfolios. Surveys commissioned by the Toronto Stock Exchange indicate that the percentage of adult Canadians who own equities either directly or indirectly (through a mutual fund) increased from 13 percent in 1983 to 23 percent in 1988.

There also been a tremendous increase in the assets of trusteed pension funds, which had assets of $176 billion dollars at the end of 1989. The pension plan of which City of Toronto employees are members (OMERS) has assets of over $12 billion. The managers of these large pension funds have created demand for a variety of sophisticated financial products, which most of the plans' members would not require if they had individually invested their retirement savings.

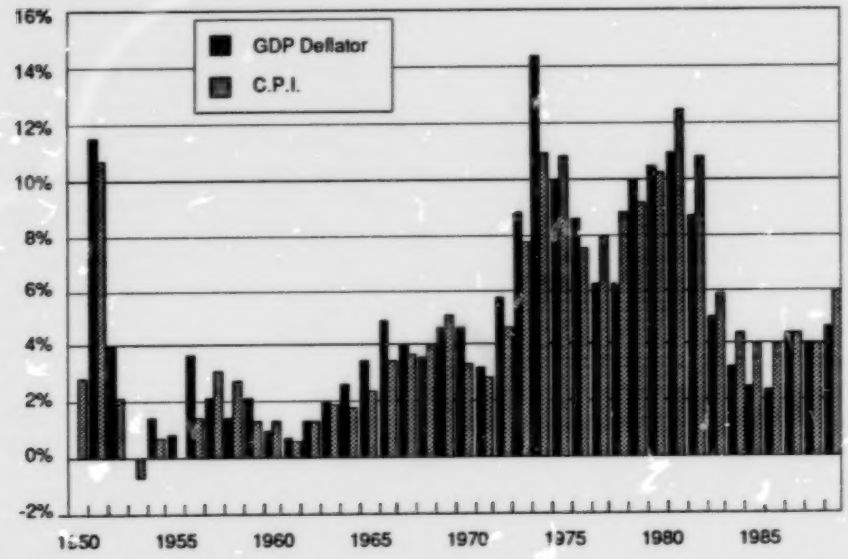
## Inflation and Exchange Rates

During most of the 1950s and 1960s inflation rates in Canada stayed at a fairly low and, even more importantly, stable rate. Between 1952 and 1969, the year to year change in the national Consumer Price Index and the Gross Domestic Product Deflator never exceeded five percent (see Chart 5). However, the oil price shocks in the 1970s and other events served to push inflation into double digits for the first time since the outbreak of the Korean war in 1951.

The two periods of double digit inflation, first 1973-75 and then 1979-81, were instrumental in changing traditional patterns of financing. In the 1980s investors have been very reluctant to provide long-term financing without adequate protection from the risk of renewed inflation.

[7] Real income is personal disposable income after accounting for the impact of inflation on purchasing power.

*Chart 5*
**Canadian Inflation Rates**




At the same time the sharpest recession since the 1930s which occurred in 1982 created pressure on management for much tighter control of financial assets and liabilities. Consumers also began to shop around more carefully for financial services. With unexpected future inflation an ever present concern, closer matching of the duration of assets and liabilities became more important for all firms not only financial institutions.

The events of the 70s and early 80s created demand for new products such as floating rate instruments as well as leading to the development of futures and swap markets.[9] Interest rates increased to unprecedented levels in the 70s in response to the high rates of inflation, in turn creating demand for sophisticated cash management systems.

The experience of rapid exchange rate fluctuations following the collapse of the Bretton Woods agreement in 1973 also contributed to the demand for new financial services products virtually unheard of ten years previously. In 1944 at Bretton Woods, New Hampshire, the major industrial countries agreed that changes in exchange rates should be made only in cases of "fundamental disequilibrium". This

[9] A swap consists of two parties exchanging financial obligations, for example fixed rate for floating rate debt or interest payments in Japanese yen for payments denominated in Canadian dollars.

system of relatively fixed exchange rates existed until 1973 when exchange rates were allowed to float more freely (see Chart 6).

*Chart 6*
**US $ Exchange Rates**
**Change from 1950**

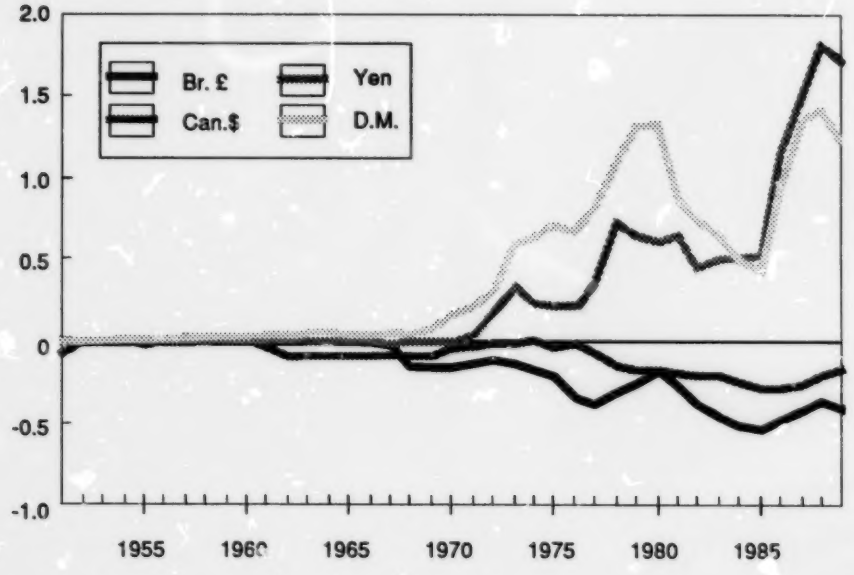



Chart 6 shows that the volatility of exchange rates escalated dramatically after 1973. Volatile exchange rates increase the risk faced by firms/individuals (with investments in more than one country or significant levels of imports/exports) of experiencing unfavourable exchange rate movements between the time an investment commitment is made or a contract is signed and the time that the actual cash or material flows take place. While volatile exchange rates imply the possibility of favourable as well as unfavourable exchange rate movements, because most economic actors are risk averse an uncertain cash flow is less valuable than a certain cash flow. Therefore, demand is created for financial products to insure against future exchange rate movements.

The data presented in Chart 6 represent average annual exchange rates. However, because exchange rates fluctuate from day to day and many cash flows are not spread out evenly over a year, the exchange rate risk faced by firms and individuals is often even larger than Chart 6 would indicate.

## International Capital Flows

Rising government deficits (until very recently) as well as large current account surpluses in Japan and West Germany also contributed to the increased demand for financial services products.

The current account balance measures total exports less imports of all goods and services. In 1989 Canada exported $142.1 billion of goods and imported $134.5 billion, for a net merchandise trade balance of $7.6 billion. In the same year, however, we had a negative balance of $24.2 billion in services trade (including interest and dividend income).[9] The combination of the above trade accounts is usually referred to as the current account balance.

A positive or negative balance in the current account must be offset by changes in foreign exchange reserves and other international capital flows; principally foreign direct investment and foreign portfolio investment (that is, the purchase of Canadian securities by foreign nationals). Canada has traditionally experienced current account deficits, causing a need for positive net foreign invesunent.

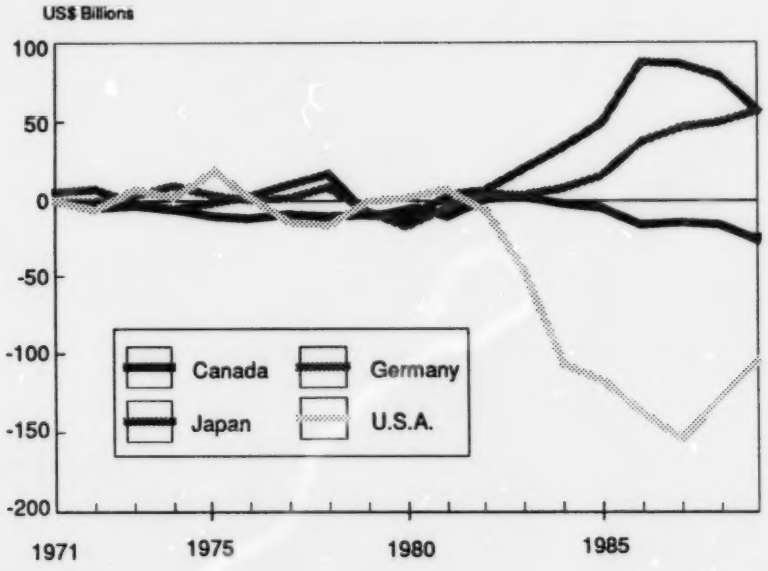
Until 1982 the current account balances of the United States, Japan and Germany were relatively small (see Chart 7), and therefore did not require large international capital flows to service. Starting in 1983, however, the United States' current deficit started to expand rapidly. At the same time, Japan and Germany began to run large surpluses. While current indications are that these capital imbalances have been recently reduced somewhat and are likely to be significantly reduced in the near future, their impact has already created international markets for a variety of financial products.

The levels of net capital flows among nations is determined by current account deficits/surpluses; however, the levels of gross capital flows are also determined by varied investor preferences internationally as well as the potential benefits to be derived from international diversification. For example, Japan is both a net lender of long-term capital as well as a borrower of short-term capital.

Financial markets have also expanded as a result of an increase in the demand for funds by governments. Central government deficits, world-wide, jumped from their historical level of less than two percent of gross domestic product to over four percent in 1975 and 1976. Subsequently, after slowing for a few years, in 1982 government deficits rose once again, this time to over five percent of G.D.P. It is only in 1987 and 1988 that we see some evidence that the size of government deficits is declining.[10]

[9] International Monetary Fund, *International Financial Statistics Yearbook, 1989*. pp. 270-275.
[10] International Monetary Fund, *Op. Cit.* p. 156.

*Chart 7*
**Current Account Balances**




While the sheer size of the U.S. economy causes its government deficits to have the most significant impact on international capital markets, and consequently to the statistics reported above, other governments including Canada's have contributed to the increased demand for funds. While the long run implications of government deficits in excess of governments' net capital investment may be very deleterious to the economy as a whole and hence to the financial services sector, in the short run these increases in the demand for funds have provided tremendous expansion opportunities for financial services firms.

## Third World Debt Crisis

The oil price shocks in 1973-74 and 1979-80, created the need to recycle the sudden transfer of wealth to the petroleum exporting countries. Because investment opportunities in the OPEC countries did not expand as rapidly as their revenues, these revenue increases had to be invested internationally. At the time much attention was focused on direct foreign investments by OPEC countries, in London real estate for example; however, most of the surpluses were redistributed by the major international banks, principally as direct loans to sovereign, often third world, governments.

The resulting loan losses for many banks have had significant impacts on how financial markets have operated in the 1980s The most important impact was to lower the credit-worthiness of many, principally United States, banks. The result of down-grading banks' credit ratings has been to increase their cost of funds. Consequently, many blue chip firms found that they could access funds directly in money markets at lower interest rates than could many banks. This cost advantage for the most highly rated firms led to a rapid expansion in the market for floating rate notes and other money market instruments.

## Regulatory Changes

While, the extent of financial services regulation varies significantly from country to country, financial services has typically been one of the most highly regulated industries. Over the last ten years, however, most countries including Canada, have significantly liberalized the regulations governing financial services. These regulations have included: currency import/export controls; exchange rate, interest rate and commission rate restrictions; financial service firm ownership restrictions; reserve requirements; and compulsory insurance schemes.

In Canada, deregulation of financial services has principally taken the form of a gradual erosion of the barriers among the four traditional "pillars" of the financial services industry (banks, trust companies, insurance companies and securities firms). In 1987 the banks had almost no presence in the securities brokerage industry, whereas today almost half of the employees in the brokerage industry work for a bank. Concurrently, the barriers to foreign firms participating in Canadian financial markets have also been relaxed.

On September 27, 1990, the federal government announced legislation further eroding the barriers among the four pillars in Canada. The main provisions of the recently announced reforms are to expand the powers of firms in all four pillars allowing for example banks to own trust and insurance companies (though not to sell insurance in bank branches). Trust companies may also own insurance companies and insurance companies will now be permitted to own trust companies. Insurance and trust companies will also be allowed to expand consumer and commercial lending. These proposed changes will increase competition among financial services firms in Canada, and some analysts speculate that they could lead to the large banks dominating the entire financial services industry.

Securities brokerage commissions have also been deregulated, the resulting price competition has lowered brokerage commissions for all traders, with commissions on large trades falling most. Deregulation has also allowed the emergence of discount brokers, providing more choice for retail consumers.[11] Lower commissions

[11] Low cost securities brokers, which execute trades for customers but do not provide research or other investment advice.

contributed to increased trading volumes on the Toronto Stock Exchange, while reducing the profitability of executing those trades. Lower costs on large trades have contributed to the institutionalization of investments as individual investors place more of their money in professionally managed investments such as mutual funds.

The same changes which lower costs in one market segment may also decrease availability of product and increase costs for other sectors. For example, a number of regulatory changes in Canada and the United States over the past several years have decreased the disclosure requirements for private placements of securities. Private placements of securities refer to the sale of securities in large amounts, usually to institutional investors (minimum investment of $250,000 in Canada), without preparation of a full prospectus.[12] While the increase in private placement activity decreases the cost of funds for large corporations and increases returns for institutional investors and very wealthy individuals, it also decreases the size and liquidity of public markets although in the long-run the privately placed securities end up traded in public markets. Proposed regulatory changes by the Securities and Exchange Commission in the United States (rule 144a), will further decrease the disclosure requirements for private placements south of the border and will accelerate the trend to private placements in Canada as well.

Generally, however, the impact of deregulating financial services has been increased competition between financial services firms in Canada for customers and for personnel, resulting in lower prices for services and higher wages for many employees. Increased competition has also cut profit margins in the financial services industry and has put more pressure on firms to innovate.

At the same time as the general trend has been to deregulate financial markets, significant examples of increased regulation can also be found. Of particular note are new international standards for bank reserve requirements and the beginnings of international coordination of securities markets regulations (IMF Apr/89). The need for these common requirements was caused by increases in cross-border activities by financial firms and was underlined by concerns raised about liquidity in international financial markets when global equity markets slumped in October, 1987.

In July, 1988, the central bank governors from twelve leading industrial countries (including Canada) signed an accord to harmonize capital standards for international banks. It does not appear that Canadian banks will have problems meeting these new capital requirements, however some adjustments will undoubtedly be required.

[12] A prospectus is a legal document which describes the securities being offered and meets the disclosure requirements of the applicable (in Canada provincial) securities legislation. It may be 30 or more pages in length and take a month or more to produce at a cost of several hundred thousand dollars.

# 4

# Response to Change

The environmental changes, outlined above, that have occurred over the last twenty years, have had a significant impact on the financial services sector. These changes have been grouped below under two headings: innovation and internationalization, and examine the response of financial sector firms to the changing environment.

## Innovation (New Products/Services)

The 1980s have seen the emergence of financial services innovations on an unprecedented scale. Many of these innovations, such as mortgages with bi-weekly payments, while of considerable benefit to many consumers, have not had a tremendous impact on how or where financial services are transacted. The four innovations examined in more detail below, however, have been identified as having the potential to significantly impact on location and staffing decisions for the financial services sector in Canada.

### Euromarket Securities

The dramatic increase in the volume of funds raised in international markets during the eighties was accompanied by a shift away from traditional bank lending (financial intermediation) towards market intermediated forms of finance, such as bonds, notes and other short-term paper. A number of new products permitted this increase in market intermediation, including note issuance facilities and floating rate notes. These were first developed in Euromarkets as replacements for syndicated bank loans.

Note issuance facilities (NIFs) are not securities, but rather standby facilities typically provided to a corporate or sovereign client by a group of banks, which guarantee the availability of funds for some specified time period, and allow the corporation to issue short-term paper in its own name with guarantees by the underwriting banks.

NIFs were first publicly announced in 1981 and by 1985 the market had grown to US $34.4 billion. After 1985, the market for NIFs has contracted substantially to US $13.2 billion in 1988. This decline was caused in part by the inclusion of NIFs in the

calculation of banks' capital requirements by various national regulatory agencies, thereby increasing the cost of providing these facilities. In addition, the ease with which NIF issuers were able to sell their notes convinced the multinational corporations and governments which had made use of the NIFs that they could issue short-term paper without the underwriting commitments of the banks.

Euro-commercial paper, which is sold by an underwriting syndicate on a best efforts basis, largely replaced NIFs in the second half of the 1980s.[13] The principal arrangers of NIFs are the large U.S. banks; however, a much broader group of banks, including Canadian banks, have significant participation in the underwriting syndicates for NIFs. Canadian firms have not been very active issuers in short-term Euromarkets in part because Canadian income tax law requires that withholding tax be paid on foreign notes issued by Canadian corporations with maturities of less than five years.

Floating rate notes (FRNs) are medium and long-term securities with interest rates that are adjusted periodically with reference to some floating rate such as LIBOR (London Interbank Offered Rate). First developed in the United States, FRNs gained significant market share in Euromarkets in the early eighties. By 1985, FRNs accounted for 35% of all international bond issues. The market for perpetual FRNs collapsed in December 1986; as a result the other segments of the market for FRNs also suffered. In 1987, FRNs accounted for only 7% of international bond issues.[14]

The seemingly short product life cycles of NIFs and FRNs serve to illustrate the importance of innovation in financial markets. Copyright protection is not available for new financial services products and large fixed capital investments are not required to take advantage of them; therefore, innovations spread very rapidly throughout the world. However, the innovating firm and those who first adopt the innovation have a considerable advantage because of the short product life cycle.

### Financial Futures and Options

Futures and options are financial contracts, which provide a way to "securitize" risks. Commodity futures were developed in the middle of the nineteenth century in the United States. At the time, prices for agricultural products were very volatile and entering into a futures contract allowed a farmer to guarantee a price for crops before planting. Financial futures and options are based on the price of some underlying financial instrument, including interest rates, exchange rates and the value of stock indexes, such as the TSE 300 or the Dow Jones Index.

Futures contracts are agreements to buy a specific commodity or financial instrument at a future date at a pre-determined price. Futures mature on standardized delivery dates and are denominated in standardized amounts. This standardization has allowed an active secondary market to emerge, mostly on organized exchanges.

[13] Promissory notes issued by major corporations in Euromarkets in large denominations with maturities from 7 to 365 days.

[14] International Monetary Fund, *International Capital Markets: Developments and Prospects* (April, 1989) p.23.

Most contracts are based on cash settlement rather than the delivery of the underlying asset, and are "unwound" before the delivery date by entering into an opposite contract.

Forward contracts are very similar to futures except that they are tailor-made instruments sold mostly by banks and securities firms. Because of their unique terms no secondary markets exist for forward contracts. One popular example of a forward contract is the forward rate agreement, whereby a bank will guarantee the interest rate on a loan or deposit at a specified time in the future.

Options differ from futures because they give the holder the right but not the obligation to buy or sell an asset. Call options permit the holder (the buyer of the option) to purchase the underlying asset at a specified price either on or before the expiry date (American options) or only on the expiry date (European options). Most options are standardized and are traded on organized exchanges; however, custom products are available from financial institutions.

Financial futures and options proliferated in the late seventies and early eighties and very rapidly gained popularity. For example, in 1979 only ten percent of U.S. futures trading was in financial futures, but by 1988 trading in financial futures accounted for 57 percent of the total.[15] The United States is the major centre for futures and options, with most of the volume transacted on three major exchanges in Chicago. London and Paris also have active futures and options markets. Japan is only now beginning to establish futures markets. Toronto and Montreal also have futures and options markets; however, these have low volumes and hence do not offer the liquidity of the major exchanges.

The Toronto Futures Exchange, established in 1984, has been successful in developing a market in stock-index futures. The development of a market in interest rate futures has, however, been much less successful. The Montreal Futures Exchange has had some success in developing a market in several interest rate option products. However, the Canadian financial system is still hampered by the lack of a liquid market in Canadian interest rate futures.

In part because futures markets lack liquidity in Canada, the over-the-counter forward markets for interest rates and foreign exchange are well developed and well served by the chartered banks.[16] According to a recent survey of Canadian corporations by the Economic Council of Canada, 60 percent of respondents had entered into a forward contract at one time. By comparison only 5 percent have used interest rate futures or options, 15% currency options and 19% currency futures.

The lack of liquidity in Canadian futures and options markets is explained in part by the restrictions placed on the investments of many financial institutions, including

[15] Economic Council of Canada, *Globalization and Canada's Financial Markets*, p. 40.

[16] Over-the-counter products are forward contracts sold by financial institutions with the selling institution as the counter-party to the contract, which are not traded on any organized exchange. These could be customized for an individual client.

pension funds, insurance companies and trust companies, which are restricted to trading in "permitted" products. Since many of the new products were developed after these laws were passed, they are not on the permitted list. Legislation is currently under consideration to allow these financial institutions to use the new products.

**Swaps**

Swaps are exchanges of financial obligations between two parties, which allow a borrower or lender to obtain/lend funds in a particular currency and with a particular interest rate structure (fixed or floating for example). The party to the swap first makes the best deal possible, and then swaps the resulting stream of payments with another borrower or lender.

A Canadian firm entering into a joint venture in France, which entitles it to fixed payments in French francs, might issue floating rate notes in the Canadian market and then swap the obligation to make floating rate Canadian payments with another firm for an obligation to make fixed rate payments in French francs. The advantage for the Canadian firm is that it could not issue fixed rate debt directly in French capital markets, except at exorbitant cost. By entering into the swap the Canadian firm is able to obtain funds at the lowest cost possible to it (presumably Canadian floating rate, in this example) as well as reducing its interest rate and currency risk exposure.

While futures and options allow firms to hedge interest rate and currency risks for relatively short periods of time, swaps are unique in providing long-term hedges of up to ten years in duration. In fact, the Economic Council of Canada was led to conclude that, "...the development of swaps is almost as important as the development of financial intermediation itself, which broke the tight link between savings and investment." [17]

When swaps first emerged in the late 70s and early 80s, banks and other financial institutions acted as intermediaries to find a counter-party for each trade. Swaps carry a credit risk, that the counter-party to the swap will not honour its commitments. Therefore, swaps were limited to the highest quality borrowers until banks began to guarantee for a fee the counter-party's payments. Today most swaps are written with a bank as the counter-party, and the banks run a swap book through which they hedge their exposure to interest rate and currency risks.

The international market for swaps has expanded substantially in the last ten years. At the end of 1988, according to the International Swap Dealers Association, $US 1.3 trillion worth of swaps were outstanding. Of this total, $US 45 billion (3.5% of total swaps outstanding) were denominated in Canadian funds.[18] It is also estimated that

[17] Economic Council of Canada. *Globalization and Canada's Financial Markets: A Research Report (1989)*, pp. 12-13

[18] *The Economist* (November 4, 1989) p.99

during the first quarter of 1989, 50% of all fixed-rate Eurobonds were swapped, and more than 75% of Canadian dollar issues.[19]

The market for swaps in Canada is well developed and is dominated by the large Schedule A banks, all of which run extensive swap books. The minimum size for a swap has decreased from $25 million in the early 80s to about $3 million today. Canadian securities firms did not run their own swap books prior to their takeover by the banks, largely because of their low capitalization. The links which have been formed between Canadian securities firms and the banks can be expected to enhance the securities firms' competitive position in underwriting Euromarket issues for Canadian firms.

The development of Canadian interest rate and currency swap markets has already contributed to the growth of Canadian dollar denominated international bond issues (7.9% of all fixed rate Eurobonds issued in 1988 were denominated in Canadian dollars).

**Asset-Backed Securities**

Securitization refers to the process whereby a financial institution creates pools of its loans and then sells securities, which flow principal and interest payments from the loans through to the investor. The first asset-backed securities, created in the US in the early 1970s, were government guaranteed residential mortgages, but more recently car loans and even credit card receivables have also been securitized. Securitization allows a financial institution to concentrate on those activities where it has a competitive advantage, and to originate and administer more loans than it has capital to hold to maturity.

The advantages of securitization are similar to those of other forms of financial intermediation, liquidity is increased for the holders of assets, such as mortgages or consumer loans, for which there are no well developed secondary markets. Increased liquidity reduces the price fluctuations of the loans, making them less risky. Opportunities for diversification are also enlarged, further reducing risk for potential, particularly small, investors.

It is estimated that 30% of outstanding residential mortgages in the US had been securitized by the end of 1987.[20] In the rest of the world, however, asset-baked securities have not yet gained much acceptance. There are a number of reasons for this, not least of which is that the US financial system is rather unique in that most residential mortgages are issued by local savings and loan companies, which would not be able to diversify their loan portfolios geographically without securitization. The large national banks and trust companies in Canada, are able to gain the full benefits of geographic diversification internally without the expense of securitization.

[19] Economic Council of Canada, *A New Frontier: Globalization and Canada's Financial Markets: A Statement* (1989) p. 54.

[20] Economic Council of Canada. *Globalization and Canada's Financial Markets: A Research Report.* (Ottawa, 1989).

The relatively narrow spread between yields on mortgages and the interest rates on government bonds in Canada has also contributed to the lack of interest in the Canadian market. While mortgage-backed securities trade to yield 100 basis points more than government bonds of similar duration in the US, the spread is only 30 basis points in Canada. By comparison the usual fee for originating asset-backed securities is about 12 basis points in Canada.[21]

There was over $1 billion of asset-backed securities outstanding in Canada at the end of 1987.[22] About half of these were CMHC guaranteed mortgages issued in 1987. On balance it appears that the reason securitization has not taken off in Canada is that there has not been as much need for it as in the US.

If securitization were to take off in Canada to the extent that it has in the United States, it is likely that domestic financial institutions would dominate the market because of the nature of the product usually disintermediated - residential mortgages and personal loans).

## Internationalization

In addition to the spate of new products and services produced by the financial services sector in the last two decades, changes have also occurred in how markets for financial services are organized world-wide. These changes include closer links between domestic financial markets and an increase in the volume of activity in Euromarkets.

### Market Linkages

The stock market crash in October, 1987, signalled just how closely linked major equity markets have become world-wide. Of 23 major equity markets world-wide, 19 declined by more than 20 percent in October, 1987.[23] The trend of major financial markets to greater integration in the 1970s and 1980s has resulted from a number of the changes identified in the previous section, principally the gradual dismantling of restrictions on international capital flows and technological advances. These changes have allowed investors to receive the benefits of international diversification.

The markets for short-term debt are even more closely linked than the market for equities among major financial markets. These links have resulted from the factors identified above as well as the emergence of new products, and increased liquidity in existing products, which now allow arbitrageurs to simultaneously buy and sell securities in world markets.

Data on cross-border capital flows indicate that Canada is no exception to the trend to increased international linkages among financial markets. Between 1973 and 1987

[21] Basil Kalymon, *Global Innovation & the Impact on Canada's Financial Markets* (Toronto, 1989) One basis point is equal to one hundredth of one percent.
[22] Economic Council of Canada, *Op. Cit.*
[23] Richard Roll, "The International Crash of October 1987", *Financial Analysts Journal*, (September, 1988) : pp.19-35.

total securities outstanding issued by Canadian governments and firms increased from $129 billion to $797 billion (a six-fold increase); however, the amount held outside Canada increased from $17 billion to $160 billion (a nine-fold increase). During this same period, Canadian holdings of foreign securities increased from $4 billion to $25 billion (a six-fold increase).[24]

**International Financial Markets**

International financial markets, often called Euromarkets, are financial markets, concentrated in London, New York and Tokyo, where securities (Eurobonds et al.) are traded, which are denominated in currencies other than the host country's. Trading of most of these securities takes place over a telephone line between one bank or brokerage firm and another. Some analysts distinguish between Eurobonds and "foreign" bonds. The latter are bonds which are issued in the domestic market of only one foreign country.

Euroequities are shares in corporations which have been issued in the domestic markets of several countries simultaneously. These are traded in the over-the-counter market similarly to bonds, and in organized stock exchanges.

The importance of international financial markets has expanded tremendously over the last decade, as their growth has exceeded that of the domestic financial markets of the major western economies including Canada's. For example, funds raised in international bond markets in 1988 were almost six times as great as in 1980.[25] At the same time, funds raised in Canadian bond markets increased by approximately 50 percent. Cross-border capital flows have also increased substantially. Gross sales of Canadian securities to non-residents rose by 850 percent in the ten years from 1978 to 1988.[26]

The eighties have also seen a relative decline in the importance of the US dollar as the denominator for international bank loans and bond issues. Canadian dollar issues of fixed rate Eurobonds have gained popularity disproportionate to the size of the Canadian economy. In 1985, 2.3% of fixed rate Eurobonds were denominated in Canadian dollars; whereas by 1988, that figure had risen to 7.9%.[27] Despite this recent increase in the importance of Canadian dollar denominated issues, the Canadian dollar does not have the same stature as an international currency as does the US dollar, the Deutschemark, the Japanese Yen and the British pound. The US dollar has also remained the main currency of issue in the markets for many short-term instruments.

Canadian institutions have, however, been losing market share in the business of managing the underwriting syndicates for Eurobonds. Between 1976 and 1988, the share of all Eurobonds managed by Canadian institutions fell from a high of 6 per-

[24] OECD, *Financial Statistics, Part 2: Financial Accounts of OECD Countries*, 1988 (Paris, 1989): pp. 90-91.
[25] Estimates by the Economic Council of Canada, in *Globalization and Canada's Financial Markets*, (Ottawa, 1989).
[26] Statistics Canada, *Security Transactions with Non-Residents*, Catalog 67-002.
[27] International Monetary Fund, *Op. Cit.* p. 99.

cent in 1976 to 2 percent in 1988. Even more unsettling, however, is that Canadian institutions have also lost market share in issues by Canadian borrowers. In 1988, Canadian institutions managed only 23 percent of Canadian dollar issues by Canadian borrowers and only 8 percent of issues by Canadian borrowers denominated in U.S. dollars.[28] At the same time, Canadian financial institutions have also been losing market share in the business of managing international loans.

The reasons put forward for the less than stellar performance by Canadian financial institutions are varied and include the following. Firstly, until the recent bank-brokerage mergers, Canadian banks were not allowed to underwrite securities in Canada and therefore did not acquire the expertise domestically to underwrite Eurobond issues. Canadian brokerage firms without the backing of the banks simply are not large enough to compete for large underwriting positions. In 1988, Nomura Securities, Japan's largest broker, had a capital base which exceeded that of the entire Canadian brokerage industry combined. The importance of minimum size is underlined by analyzing Canadian firms' market share by size of issue. For example, between 1980 and 1988, Canadian firms managed 47 percent of U.S. dollar issues by Canadian corporations that were for less than $50 million, but only 17 percent of issues over $100 million.[29]

The Economic Council of Canada has also observed that Canadian firms have not been as aggressive in their pricing strategies as many of their competitors.[30] Competition in Eurobond markets has been very fierce in the 1980s, resulting in very low profit margins for firms operating in these apparently over-banked markets. Whether in the long-run Canadian firms would have been better off not to have withdrawn from Euromarkets is difficult to determine. However, one must assume that the managers of the Canadian firms which have scaled back their Euromarket operations did so in order to maximize the long-run value of their firms to their shareholders.

Finally, one should note that Canadian firms do maintain a strong presence among foreign firms in London - where most of the Euromarket transactions are arranged. In 1988, Canadian banks and securities firms employed some 3,400 people in London, third after U.S. institutions with 21,700 and Japanese with 6,500.

### International Financial Centres

International financial centres are the primary global centres for international financial transactions and should not be confused with the changes to the Canadian Income Tax Act implemented in 1987 which created the "International Banking Centre" designation for certain tax-free transactions in Vancouver and Montreal.

International financial centres are clearing houses for a large variety and volume of international financial transactions. The rise of international financial centres ap-

[28] Economic Council of Canada, *Globalization and Canada's Financial Markets* pp. 71-80.
[29] *Ibid.* p.77.
[30] *Ibid.* p.78.

pears to be caused by a phenomenon similar to the natural monopoly. The broader a financial market, the greater the liquidity; therefore, borrowers are able to raise larger sums of money at lower rates of interest, because lenders are willing to accept lower rates of return for more marketable, and hence less risky securities.

In addition to the cost advantages, there appear to be positive externalities for firms located in major financial centres. These externalities are associated with the exchange of information about new financial products, economic events and firm-specific information. Much of this information is of an informal nature, such as rumours, hence direct personal contact is required.

The other reason usually cited for the tendency of financial services to cluster in one area, is the need for face to face contact when major financial transactions are negotiated. For example, directives to the loan managers in branches of the major Canadian banks stress the importance of direct contact in the lending process.[31] Most persons place greater confidence in the reliability of information gathered from face-to-face contact.

Other factors which have been cited as contributing to the development of an international financial centre are: a stable currency, the existence of domestic institutions capable of handling a wide variety of international transactions, favourable regulations for domestic as well as foreign market participants, political stability, well-developed foreign exchange, money and capital markets, a history of international commerce, good transportation and communication links with the rest of the world, well educated local labour pool, strong business services sector (including many specialized services) and a living environment considered desirable by potential employees. Finally, a predominantly English-speaking environment is also likely to be an advantage for a newly emerging major financial market.

> *Thus London should benefit from the economic integration of Europe. One subtle factor is language: We do not believe that the Japanese will seek to become proficient in a second occidental language. This language barrier may make it difficult for both France and West Germany to compete effectively in the market for world financial services.*[32]

London and New York are generally recognized as the preeminent financial centres in the world, with Tokyo being included as a dominant centre more recently (last 5-10 years). London was the principal financial centre of the world in the nineteenth century. New York's rise to preeminence is usually ascribed to the United States' dominance of the post World War II economy with particular emphasis on the role of the US dollar as the principal reserve currency in the world. Some analysts have argued that London once again surpassed New York in the 1970s with the emergence of Euromarkets. Tokyo's recent ascendancy can be ascribed to two

[31] Economic Council of Canada, *Globalization and Canada's Financial Markets*, p. 66.
[32] Solomon Brothers, *London Office Market* (New York, 1988) p.12

factors: first Japan's recent large surpluses of cheap funds available for investment, and second Japan's physical position in a time zone halfway between New York and London. Major financial institutions now maintain operations in New York, London and Tokyo, permitting them to offer 24 hour trading 5 days per week on inter-listed products.

The importance of global financial centres has increased in the last twenty years, because a greater proportion of the world's financial transactions appear to be flowing through these centres. It is difficult to determine whether these trends to increased centralization will continue. The Economic Council of Canada concludes that:

> *For Canada, the major reality is that it is unlikely to be host to one of the world's leading financial centres. It is also likely that increasing portions of Canadian financial activity will be conducted abroad in international financial centres, wherever they are located.*[33]

While it is reasonable to accept that Toronto is unlikely to become a first tier financial centre to rival New York and London, there are limits to how much of Canada's financial services business will be conducted in these centres. Most financial services are intrinsically domestic.

Examples of financial services which are unlikely to go offshore include not only the retail side of the business, but also to serving many of the needs of most Canadian corporations. For example, firms use financial markets to issue debt and equity securities in order to raise money for capital investments. However, only a very few Canadian corporations are large enough to have the name recognition required to access funds directly in London or Tokyo. These major firms and governments have been accessing foreign markets for decades and will continue to do so; however, security issues by most Canadian companies will continue to be sold primarily in Canadian markets. The recently reported desire by Varity Corporation to move its head office to the United States was justified by the firm's management in part by the desire to appear on the Fortune 500 list of major US corporations – in order to access funds in foreign markets at more advantageous rates.

There is also a minority view that as improvements in telecommunications and computer technology continue, financial centres will become less important. This scenario is more likely to prevail if the rate of innovation in financial products was to slow down and the existing products were to become more like commodities. While there is no indication at this time that the rate of innovation in the financial services sector is beginning to slow, one could postulate that most of the benefits of financial services innovation are already available with currently available financial products. In this view, the next round of innovation will create less value, and most of the future changes would be of a market broadening, or niche marketing, nature.

[33] Economic Council of Canada, *Globalization and Canada's Financial Markets*, p. 66.

*The unprecedented proliferation of financial products engineered by the investment banking community further enhanced New York's dominance. The emergence of "high tech" finance created new profit opportunities and higher trading volumes as new securities and methods of trading were created. Although financial innovation is continuing, this trend appears to be slowing because of reduced profit margins. In addition, the risks associated with several new financial products have turned out to be greater than anticipated.*[34]

[34] Salomon Brothers, *New York Metropolitan Area Office Market*, (New York, 1988) p.4.

# 5

# Conclusions

Financial services employees comprise roughly one fifth of all employees in Toronto's Central Area. In the Toronto CMA (data were unavailable specific to the Central Area) they are generally a well paid group, whose average incomes have been rising relative to employees in other industries. The proportion of employees in the lowest income category (less than $10,000 per year in 1985) is also lower in the FIRE sector than in other industries in the CMA.

Over the last two decades the financial services sector in Canada has experienced rapid increases in output and employment, as demand for financial services has outpaced the underlying growth in the economy. The Toronto CMA, and more particularly Toronto's Central Area, have attracted a disproportionate share of the resultant employment gains.

The reasons for the increase in financial services output include: the growing sophistication of both investors and borrowers as well as the employees of financial services firms, a trend which is likely to continue. The rapid expansion in new products and services demanded by the increasingly sophisticated participants in financial markets was facilitated by advances in technology, particularly computer technology, and by the deregulation of the industry, which reduced costs and profit margins and, therefore, increased demand for these products. The increased volatility in inflation, interest rates and exchange rates experienced in the past two decades also contributed to the demand for a variety of new products to reduce the risks of unexpected moves in these, previously rather stable, variables.

In the future, it is reasonable to expect that the sophistication of financial market participants (both consumers and employees of financial services firms) will continue to increase, particularly at the retail level. While future improvements in computer and telecommunication technologies do not promise the kind of quantum advances experienced in the last several decades, there is substantial room for increased market penetration of these technologies. The increased volatility in financial markets is not showing any sign of abating (except perhaps inflation), and

as the baby boom generation enters middle age, and begins to save an increasing proportion of their incomes in anticipation of eventual retirement, demand for many savings vehicles will be enhanced. For these reasons, it is expected that the output of the financial services sector will continue to increase at a rate faster than the rate of all goods and services.

The sale of most financial products is not easily automated, requiring face to face contact, therefore one can expect that employment growth in the financial services sector will continue to expand as output grows.

While there is no statistical evidence yet of a downturn in financial services (FIRE employment increased in the Toronto CMA in the third quarter of 1990), in the short-run it is possible that employment levels will stagnate or even decline marginally as equity prices and market volumes remain low and bank profits and share prices decline. These depressing short-run impacts may be partly offset by the impact of the recently announced financial services regulatory reforms, which should increase competition as firms gear up to enter lines of business previously closed to them.

While it is reasonable to expect that employment levels will continue to expand in the long-run, some analysts speculate that wages and salaries (for some of the highest paid individuals) may moderate. According to The Economist the already falling monopoly profits of financial services firms will continue to decline as "More individuals, and certainly most firms, will be able to call up on screens an aggregation of their assets, with a menu of choices on where to hold or invest them." [35] It is estimated that the income of financial institutions now accounts for over ten percent of gross world product, up from a fraction of that a decade ago. The Economist argues that this is too high a proportion to sustain indefinitely.

To determine how the financial services sector in Toronto will fare one must speculate about whether Toronto will lose business to the dominant global financial centres, and because of our geographic location, particularly to New York City. Over the past decade the volume of international financial transactions has clearly grown at a rate which exceeds the growth of domestic financial transactions in any of the major economies, and a disproportionate share of this international business is transacted in the dominant global financial centres. What is much less clear, however, is whether these trends will continue.

The view that the globalization of the financial services industry may spell the demise of Toronto's financial services sector has been popularized by Colin Vaughan (citing Joe Berridge's May 1989 Cityplan Forum paper):

[35] *The Economist* (September 8, 1990) p.23.

> *Berridge supports his thesis by pointing out that while the financial services sector is one of Toronto's biggest employers, its activity does not create wealth but simply redistributes it. As a result, the banking and brokerage business "could disappear down a fibre-optic cable to London or New York or Tokyo in a few years."* [36]

The assertion that financial services add no value is clearly unsubstantiated. Without financial services, the standard of living that Canadians enjoy would be dramatically reduced. If financial services were unavailable people would all have to match their current consumption and incomes at every point in time or "save" at zero interest rates. Most people would be unable to purchase a home, and many people would find it difficult to buy an automobile. Similarly, it is hard to imagine how many auto plants would have been built in the first place, in the absence of limited liability companies with publicly issued debt and equity.

More importantly, there is no indication why financial services would disappear down a fibre-optic cable. In the same article, Berridge is cited as enumerating the attributes which are unique to Toronto among most large cities: clean, relative racial harmony, no extensive underclass, good public schools. These attributes could give Toronto a significant comparative advantage in competing for a larger share of global financial services business, because of the desire of employees to live in Toronto.

Finally, because of our geographic proximity to New York City, one must look more closely at New York's prospects. While no one is predicting New York's imminent demise,

> *Over the longer term, economic growth in the metropolitan area will be constrained by an eroding monopoly in the financial services area and an increasing labour shortage that is being exacerbated by a troubled urban educational system, high house prices and a dilapidated infrastructure.*[37]

Salomon Brothers also indicate that New York's share of United States' security and commodity broker jobs has dropped from 45% of total US brokerage employment in 1970 to 37% in 1980 and 36% in 1987, despite the financial services boom in New York in the eighties. Salomon Brothers predicts that New York will continue to lose market share to other United States cities (principally Los Angeles) and foreign financial centres.

A recent report on the future of New York as the world financial centre identified "the ability of firms to hire sufficient numbers of qualified workers." as the key challenge faced by New York's financial services sector, because "Firms have found that a New York City high school diploma does not mean that an applicant will have the basic skills required for an entry-level job in the industry." [38]

[36] The Globe and Mail, *Toronto*, (October, 1988) p.32
[37] Salomon Brothers, *New York Metropolitan Area Office Market*, p.2.
[38] New York City Partnership, Financial Services Task Force, *Meeting the Challenge: Maintaining and Enhancing New York City as the World Financial Capital* (New York, 1989), p.18.

While one cannot predict the future, from the above analysis it appears that the long-run success or failure of the financial services sector in Toronto rests, for the most part, on Toronto's ability to continue to maintain an attractive living and working environment for both highly paid professionals as well as clerical employees. These quality of life considerations are central to the Official Plan review currently underway.

# 6

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# Appendix

*Table 1*
**FIRE Employment in Canada**

| | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **FIRE** | | | | | | | | | | | | | | | |
| Canada * | 496 | 531 | 546 | 554 | 611 | 594 | 601 | 601 | 633 | 629 | 657 | 698 | 728 | 733 | 755 |
| Ont. * | 217 | 222 | 232 | 237 | 252 | 247 | 250 | 250 | 272 | 255 | 274 | 302 | 324 | 318 | 341 |
| To CMA * | 109 | 114 | 119 | 127 | 136 | 139 | 142 | 136 | 151 | 143 | 156 | 179 | 179 | 173 | 189 |
| Metro ** | | | | | | 110 | 107 | 107 | 114 | 112 | 121 | 131 | 137 | 148 | |
| C A ** | | | | | | 66 | 63 | 62 | 71 | 67 | 74 | 78 | 79 | 86 | |
| **All Empl.** | | | | | | | | | | | | | | | |
| Canada * | 9,477 | 9,651 | 9,987 | 10,395 | 10,708 | 11,001 | 10,618 | 10,675 | 10,932 | 11,221 | 11,521 | 11,861 | 12,244 | 12,486 | 12,572 |
| Ont. * | 3,643 | 3,708 | 3,835 | 3,993 | 4,053 | 4,171 | 4,063 | 4,089 | 4,235 | 4,377 | 4,524 | 4,689 | 4,862 | 4,949 | 4,937 |
| To CMA * | 1,338 | 1,354 | 1,413 | 1,501 | 1,541 | 1,632 | 1,586 | 1,593 | 1,635 | 1,709 | 1,779 | 1,848 | 1,892 | 1,940 | 1,931 |
| Metro ** | | | | | | 1,179 | 1,143 | 1,104 | 1,142 | 1,182 | 1,223 | 1,276 | 1,319 | 1,357 | |
| C A ** | | | | | | 365 | 353 | 351 | 363 | 372 | 390 | 405 | 412 | 431 | |
| **FIRE/All Empl.** | | | | | | | | | | | | | | | |
| Canada * | 5.2% | 5.5% | 5.5% | 5.3% | 5.7% | 5.4% | 5.7% | 5.6% | 5.8% | 5.6% | 5.7% | 5.9% | 5.9% | 5.9% | 6.0% |
| Ont. * | 6.0% | 6.0% | 6.0% | 5.9% | 6.2% | 5.9% | 6.2% | 6.1% | 6.4% | 5.8% | 6.1% | 6.4% | 6.7% | 6.4% | 6.9% |
| To CMA * | 8.1% | 8.4% | 8.4% | 8.5% | 8.8% | 8.5% | 9.0% | 8.5% | 9.2% | 8.4% | 8.8% | 9.7% | 9.5% | 8.9% | 9.8% |
| Metro ** | | | | | | 9.3% | 9.4% | 9.7% | 10.0% | 9.5% | 9.9% | 10.3% | 10.4% | 10.9% | |
| C A ** | | | | | | 18.1% | 17.8% | 17.7% | 19.6% | 18.0% | 19.0% | 19.3% | 19.2% | 20.0% | |
| **Toronto CMA** | | | | | | | | | | | | | | | |
| Relative Concentration *** | 1.56 | 1.53 | 1.54 | 1.59 | 1.55 | 1.58 | 1.58 | 1.52 | 1.59 | 1.49 | 1.54 | 1.65 | 1.59 | 1.52 | 1.63 |

* *Statistics Canada, Labour Force Survey*
** *Metro Planning Dept., Annual Employment Survey 1981/82 data estimated from full-time employment*
*** *Relative concentration equals the ratio of the area's share of national FIRE employment divided by the area's share of total national employment*

*Table 2*
**Central Area Total Employment**

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|
| Bank & Trust Branch | 6,794 | 7,927 | 8,388 | 12,074 | 10,550 | 6,869 | 7,878 |
| Bank & Trust H. O. | 14,230 | 21,043 | 19,322 | 20,805 | 24,314 | 26,715 | 31,961 |
| sub-total | 21,024 | 28,970 | 27,710 | 32,879 | 34,864 | 33,584 | 39,839 |
| Invest Services | 10,200 | 11,254 | 10,763 | 11,397 | 14,284 | 15,156 | 14,302 |
| Financing | 4,265 | 4,760 | 2,757 | 1,994 | 2,997 | 2,219 | 2,441 |
| sub-total | 14,465 | 16,014 | 13,020 | 13,391 | 17,281 | 17,375 | 16,743 |
| Insurance Co. | 25,487 | 20,316 | 20,420 | 19,687 | 19,464 | 21,288 | 20,057 |
| Other Insurance | 1,514 | 1,537 | 1,495 | 2,076 | 1,288 | 1,532 | 2,879 |
| sub-total | 27,001 | 21,853 | 21,915 | 21,763 | 20,752 | 22,820 | 22,936 |
| Misc FIRE | 569 | 799 | 1,065 | 1,480 | 477 | 724 | 824 |
| **Financial Services** | **63,059** | **67,636** | **63,710** | **69,513** | **73,374** | **74,503** | **80,342** |
| R/E Developers | 948 | 1,372 | 1,691 | 1,920 | 2,351 | 2,655 | 3,405 |
| R/E Agents | 1,392 | 1,617 | 1,720 | 2,148 | 2,301 | 2,189 | 2,614 |
| sub-total | 2,340 | 2,989 | 3,411 | 4,068 | 4,652 | 4,844 | 6,019 |
| **FIRE Total** | **65,399** | **70,625** | **67,121** | **73,581** | **78,026** | **79,347** | **86,361** |
| **Office Total** | **209,531** | **219,697** | **224,038** | **233,429** | **245,021** | **253,485** | **266,600** |
| **All Employ Total** | **351,100** | **363,068** | **371,741** | **390,144** | **405,453** | **411,639** | **431,351** |

*Source: Metro Planning Dept Annual Employment Surveys (1983-89)*

*Table 3*
**Central Area Proportion of Total Metro Employment**

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|
| Bank & Trust Branch | 33.5% | 37.5% | 39.6% | 48.8% | 43.4% | 32.3% | 35.1% |
| Bank & Trust H. O. | 72.2% | 77.0% | 75.5% | 75.1% | 77.6% | 77.5% | 79.2% |
| sub-total | 52.5% | 59.8% | 59.2% | 62.7% | 62.7% | 60.2% | 63.4% |
| Invest Services | 93.2% | 91.9% | 88.7% | 91.8% | 90.5% | 90.6% | 89.3% |
| Financing | 77.1% | 81.4% | 71.9% | 59.3% | 64.2% | 54.3% | 56.0% |
| sub-total | 87.8% | 88.5% | 84.5% | 84.8% | 84.5% | 83.4% | 82.2% |
| Insurance Co. | 73.9% | 70.7% | 71.6% | 70.7% | 65.2% | 64.4% | 60.6% |
| Other Insurance | 32.8% | 32.5% | 30.5% | 34.2% | 25.5% | 30.3% | 47.9% |
| sub-total | 69.1% | 65.3% | 65.6% | 64.1% | 59.4% | 59.9% | 58.6% |
| Misc FIRE | 46.1% | 51.3% | 42.6% | 52.9% | 32.3% | 42.2% | 45.2% |
| **Financial Services** | **65.1%** | **66.6%** | **64.9%** | **66.2%** | **65.2%** | **64.0%** | **64.7%** |
| R/E Developers | 47.1% | 51.2% | 53.9% | 50.7% | 54.5% | 52.9% | 53.4% |
| R/E Agents | 16.2% | 17.2% | 16.6% | 18.1% | 16.2% | 14.1% | 14.5% |
| sub-total | 22.0% | 24.8% | 25.2% | 25.9% | 25.1% | 23.6% | 24.7% |
| **FIRE Total** | **60.9%** | **62.1%** | **60.1%** | **61.0%** | **59.6%** | **58.0%** | **58.2%** |
| **Office Total** | **45.7%** | **45.4%** | **45.1%** | **45.3%** | **44.2%** | **43.3%** | **43.4%** |
| **All Employ Total** | **31.8%** | **31.8%** | **31.5%** | **31.9%** | **31.8%** | **31.2%** | **31.8%** |

*Source: Metro Planning Dept Annual Employment Surveys (1983-89)*

*Table 4*
**FIRE Labour Force Profile (Toronto CMA)**

| | No. of Employ | Income <10k | Income 10-19k | Income 20-29k | Income 30-39k | Income 40-49k | Income > 50k |
|---|---|---|---|---|---|---|---|
| **FIRE Sector** | | | | | | | |
| Mkt Search | 35,505 | 11.0% | 19.6% | 23.7% | 15.6% | 9.5% | 20.6% |
| Consulting | 33,840 | 4.0% | 12.1% | 29.1% | 23.2% | 15.2% | 16.5% |
| Admin & Mgmt | 12,695 | 4.1% | 10.6% | 20.4% | 14.0% | 13.6% | 37.3% |
| Clerical | 59,580 | 24.6% | 49.1% | 21.6% | 3.2% | 0.9% | 0.7% |
| All Others | 30,420 | 20.1% | 35.0% | 27.4% | 10.3% | 3.8% | 3.4% |
| **Total** | **172,040** | **15.4%** | **30.3%** | **24.4%** | **11.8%** | **7.0%** | **11.1%** |
| **All Industries** | | | | | | | |
| Mkt Search | 93,830 | 11.7% | 20.4% | 24.5% | 18.7% | 10.5% | 14.2% |
| Consulting | 165,615 | 11.9% | 15.9% | 24.7% | 20.7% | 12.5% | 14.2% |
| Admin & Mgmt | 191,280 | 6.9% | 13.9% | 19.7% | 17.0% | 14.3% | 28.1% |
| Clerical | 381,935 | 30.2% | 38.4% | 23.8% | 5.7% | 1.3% | 0.7% |
| All Others | 1,315,050 | 28.4% | 25.0% | 21.4% | 14.4% | 6.4% | 4.2% |
| **Total** | **2,147,710** | **24.8%** | **25.5%** | **22.1%** | **13.8%** | **6.9%** | **7.0%** |

| | Age % 15-24 | Age % 25-44 | Age % 45-64 | Age % >65 | Part time % | Female % |
|---|---|---|---|---|---|---|
| **FIRE Sector** | | | | | | |
| Mkt Search | 7.2 | 56.6 | 32.0 | 4.2 | 8.0 | 37.9 |
| Consulting | 5.1 | 75.7 | 18.5 | 0.7 | 3.1 | 46.2 |
| Admin & Mgmt | 4.9 | 60.2 | 32.1 | 2.8 | 5.0 | 40.1 |
| Clerical | 28.8 | 51.9 | 18.0 | 1.3 | 21.0 | 86.2 |
| All Others | 17.1 | 52.6 | 28.0 | 2.3 | 12.4 | 54.4 |
| **Total** | **15.9** | **58.3** | **23.8** | **2.1** | **12.0** | **59.4** |
| **All Industries** | | | | | | |
| Mkt Search | 9.7 | 59.2 | 28.1 | 2.9 | 7.4 | 33.6 |
| Consulting | 10.9 | 67.2 | 20.5 | 1.4 | 7.8 | 39.0 |
| Admin & Mgmt | 6.7 | 58.0 | 33.3 | 2.1 | 4.5 | 31.1 |
| Clerical | 28.9 | 47.3 | 22.4 | 1.4 | 24.8 | 78.3 |
| All Others | 22.9 | 48.7 | 26.7 | 1.7 | 18.2 | 39.3 |
| **Total** | **21.0** | **51.2** | **26.1** | **1.7** | **16.8** | **45.3** |

*Source: 1986 Census, Special Tabulations for City of Toronto Planning and Development Department*

*Table 5*
**Financial Centre Employment**

| Employment (thousands) | Toronto 1987 | Chicago 1986 | Los Angeles 1986 | New York 1987 | London 1987* |
|---|---|---|---|---|---|
| FIRE CMA | 176 | 251 | 268 | 851 | 711 |
| Total CMA | 1,845 | 2,948 | 3,910 | 8,064 | 3,490 |
| FIRE Nat'l | 729 | 6,298 | 6,298 | 6,491 | 2,321 |
| Total Nat'l | 12,356 | 99,620 | 99,620 | 102,215 | 21,343 |
| CMA FIRE employ | | | | | |
| % Total CMA ** | 9.54% | 8.51% | 6.85% | 10.55% | 20.37% |
| % Nat'l FIRE | 24.14% | 3.99% | 4.26% | 13.11% | 30.63% |
| % Nat'l Total | 14.93% | 2.96% | 3.92% | 7.89% | 16.35% |
| FIRE Relative Concentration | 1.62 | 1.35 | 1.08 | 1.66 | 1.87 |

* FIRE Includes Business Services

** Relative concentration equals the ratio of the area's share of national FIRE employment divided by the area's share of total national employment

*Source: Salomon Brothers, Real Estate Market Reviews (various issues)*

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